Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:NEW:1:POSTF-149675-01
RTBennett

date: October 17,2001

to: Sharon Ludwin, Revenue Agent

from: William F. Halley, Associate Area Counsel, LMSB

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subject: **Taxpayer:** [redacted]
TIN: [redacted]
Tax Years: [redacted], [redacted], [redacted] **and** [redacted]
UILs: 274.14-00, 274.08-00, 132.04-01

DISCLOSURE STATEMENT

This memorandum responds to your request for assistance dated June 8, 2001. This memorandum should not be cited as precedent.

I. Facts.

The taxpayer [redacted] ("[redacted]") has filed claims for refund for tax years ending [redacted], [redacted], [redacted], and [redacted]. [redacted] asserts in the claims that certain meals and entertainment expenses originally reported on its income tax returns for these years were improperly computed under the 50 percent limitation of section 274(n).[1] Generally, [redacted] argues that certain meals were (1) entertainment expenses for the benefit of employees under section 274(e)(4) or (2) de minimis fringe benefits under section 132. See section 274(n)(2)(A) and (B) exceptions. The expenses are varied but include meals during group meetings both on site and at restaurants, and summer associate/ intern outings. [redacted] also claims some expenses were inadvertently included as meals/ entertainment but rather should be considered strictly under section 162.

[redacted] ("[redacted]") performed the evaluation of the expenses. [redacted] or [redacted] selected approximately seven of its largest branches located in the United States and

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[1]Unless otherwise indicated, all section references denote the Internal Revenue Code of 1986, as in effect for the years in issue.

reviewed the expenses taken subject to the section 274(n) limitation. [redacted] did not use a statistical sample to extrapolate the results to any other branches.[2] Consequently, with regards to these claims for refund, the only issue is whether [redacted] has properly substantiated the expenses claimed to fall under an exception.

On [redacted], two representatives from [redacted] met with the audit team and an attorney from Counsel as well as representatives from [redacted]. [redacted], a partner from [redacted] who handles [redacted]'s section 274 projects, presented the issue. [redacted] had previously supplied the audit team with written discussions of sections 274 and 132 and their general application to the [redacted] project.

[redacted] initially explained that [redacted] documents meals and entertainment expenses under two separate methods, expense reports and accounts payable. [redacted] initially began to look through the expense reports but the number of expenses was extremely large. The accounts payable were more manageable in number and therefore only the accounts payable were reviewed. [redacted] claims that this was done despite "opportunity" in the expense reports. The accounts payable made up about [redacted]% of the total expenses for meals and entertainment. [redacted] remarked that, therefore, they actually only reviewed [redacted]% of the amount of expenses that potentially could have been changed from the [redacted]% allowance to [redacted]%.

[redacted] explained that [redacted] individuals from [redacted] actually went to [redacted] to review the records and spent approximately [redacted] weeks. There was no written plan on how to go through the documents. There were no written programs or instructions on how to determine whether a given expense was eligible for an exception to the 50% limitation.

[redacted] explained how the team determined that an expense met the recreation exception provided for under section

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[redacted], (b)(5)(AC), (b)(7)e

274(n)(2)(A) and (e)(4).[3] First, it was determined whether employees attended. Second, the team confirmed that the employees actually attended. [redacted] did not state how this was done. As far as determining that the expense did not primarily benefit highly paid employees, she stated that the team made a "judgmental call." She stated that there was no formal test done to determine who was highly compensated under section 414(q). She stated that they knew who the officers and directors were because they had employee directories to review. The team would look to see if officers or directors attended a given event. [redacted] did not state that anything was done beyond this.

[redacted] explained how the team determined that an expense met an exception to the section 274(n) limitation as a de minimis fringe under sections 274(n)(2)(B) and 132. She specifically stated that the team did not determine the per employee cost of an event i.e., total cost divided by number of employees benefitting. She stated that this would have been administratively burdensome even if the numbers were available. It should be noted that only recently [redacted] has revised how certain expenses should be categorized. For example, recently [redacted] has claimed that certain expenses should be considered overtime meals (presumably under Treas. Reg. §1.132-6(b)'s "special rule"), despite having never claimed any of the expenses as overtime meals in the past, rather only relying on the "infrequency" and nominal cost language of the regulations. (presumably under Treas. Reg. 1.132-6(a)'s "general rule"). Further, in its revised spreadsheet, [redacted] lumps "group meals" together with "overtime meals." However, it is not delineated at all under which of these two groups a given expense is considered. Also, [redacted] did not explain how [redacted] determined that a given meal was necessitated by overtime work.

The agent requested our advice whether the taxpayer's methodologies in determining the application of the exceptions to section 274(n) to its expenses were legally sufficient.

II. Issue.

Whether the taxpayer has satisfied the legal requirements under section 274(n)(2) in order to re-characterize certain meal and entertainment expenses from 50 percent deductible to 100 percent?

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[3] See Section III, infra for legal discussion of section 274(n).

III. Discussion.

A. Introduction

Section 162 provides that a taxpayer may deduct ordinary and necessary expenses incurred in the operation of a trade or business. However, the amount of the deduction may be completely eliminated or limited under section 274. Generally, a taxpayer may not deduct more than 50 percent of the amount of an expense for food or beverage or entertainment. Section 274(n)(1)(A). Section 274(n)(2) provides for exceptions from the 50 percent limitation imposed by section 274(n)(1). For example, the limitation does not apply to expenses covered under section 274(e)(4). Section 274(n)(2)(A). Section 274(e)(4) covers expenses incurred for recreational, social or similar activities primarily for the benefit of non highly compensated employees. Also, the limitation does not apply in the case of an expense for food or beverage if such expense is excludable from the gross income of the recipient under section 132 by reason of section 132(e) relating to de minimis fringes. Section 274(n)(2)(B).[4] However, the limitation does apply to expenses incurred by taxpayer which are directly related to business meetings of his employees, stockholders, agents, or directors. Section 274(e)(5).

B. Entertainment for benefit of employees.

Generally, expenses for entertainment, amusement or recreation are not deductible unless directly related to, or associated with, the active conduct of the taxpayer's trade or business. Section 274(a)(1)(A). However, section 274(e) provides for certain specific exceptions or safe havens from the disallowance provisions of section 274(a)(1)(A). [5] However any

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[4]This advisory does not address whether the expenses (1) are ordinary and necessary under section 162, (2) are lavish or extravagant under section 162 or (3) may be denied or limited under any other authority.

[5]Section 274(n)(2)(A) states that numerous types of expenses as listed under section 274(e) are excepted from the 50% limitation. Tellingly absent from the list is (5) of section 274(e) which provides for "expenses incurred by a taxpayer which are directly related to business meetings of his employees, stockholders, agents, or directors."

meal and entertainment type expenses which are not disallowed under section 274(a)(1)(A) (by reason of section 274(e) or otherwise) are generally limited to 50 percent of the amount otherwise allowable unless they meet the exceptions of section 274(n)(2) (in which case they are 100 percent deductible). The exceptions of section 274(n)(2) include expenses described in section 274(e)(4) and de minimis fringes.

Section 274(e)(4) provides that the general limitation is not applicable to "[e]xpenses for recreational, social, or similar activities (including facilities therefor) primarily for the benefit of employees (other than employees who are highly compensated employees (within the meaning of section 414(q)).[6]

Entertainment is defined as "any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic cubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family." Treas. Reg. §1.274-2(b)(1).

Treas. Reg. §1.274-2(f)(2)(v) states that section 274(e)(4) expenses of an employer ordinarily cover "usual employee benefit programs such as expenses of a taxpayer (a) in holding Christmas parties, annual picnics, or summer outings, for his employees generally, or (b) of maintaining a swimming pool, baseball diamond, bowling alley, or golf course available to his employees generally." The regulations further provide that "an expenditure for an activity will not be considered outside of

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[6] The event can not be primarily for the benefit of officers, directors, ten percent owners in the employer, or highly compensated employees. Treas. Reg. §1.274-2(e)(v). Section 414(q) defines "highly compensated employee" as "any employee who-...(B) for the preceding year- (i) had compensation from the employer in excess of $80,000 and (ii) if the employer elects the application of this clause for such preceding year, was in the top paid group of employees for such preceding year." "Top paid group" is generally the "top 20 percent of the employees based on compensation." Section 414(q)(3). See Treas. Reg. §1.414(q)-1T, Q.9 for determining "top paid group."

The regulations under section 274 substitute "expenditure" for "expense." The regulations define "expenditure" to "include expenses paid or incurred for goods, services, facilities, and items (including items such as losses and depreciation)." Treas. Reg. §1.274-2(b)(2)(i).

this exception merely because, due to the large number of employees involved, the activity is intended to benefit only a limited number of such employees at one time, provided the activity does not discriminate in favor of officers, shareholders, other owners, or highly compensated employees." Id..

Pursuant to the regulations, the taxpayer has to "keep records or other evidence as shall be necessary to establish that such expenses were for activities (or facilities used in connection therewith) primarily for the benefit of employees other than employees who are officers, shareholders or other owners (as defined in section 274(e)(5)), or highly compensated employees." Id..

C. De minimis fringe.

Gross income does not include any fringe benefit which qualifies as a de minimis fringe. Section 132(a)(4). A de minimis fringe is generally defined as "any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable." Section 132(e)(1). Examples of de minimis fringe benefits include

> "occasional typing of personal letters by a company secretary, occasional personal use of an employer's copying machine, provided that the employer exercises sufficient control and imposes significant restrictions on the personal use of the machine so that at least 85 percent of the use of the machine is for business purposes, occasional cocktail parties, group meals, or picnics for employees and their guests, traditional birthday or holiday gifts (not cash) with low fair market value, occasional theater or sporting event tickets, and coffee and doughnuts." Treas. Reg. §1.132-6(e)(1). Generally, the frequency by which a fringe is provided is done on an "employee by employee" basis. Treas. Reg. §1.132-6(b)(1).

However, if it is administratively difficult to determine frequency on an employee by employee basis, it can be determined by looking at the workplace as a whole. Treas. Reg. §1.132-6(b)(2). The nondiscrimination rules of section 132(h)(1) and Treas. Reg. §1.132-8 generally do not apply in determining the amount of a de minimis fringe. Treas. Reg. §1.132-6(f).

The regulations also provide for "special rules." Treas. Reg. §1.132-6(d). Treas. Reg. §1.132-6(d)(2)(i) states in part that a meal provided to an employee is excluded from income as a de minimis fringe if the "benefit is reasonable" and satisfies three conditions. The three conditions are (A) the meal is provided to the employee on an occasional basis; (B) the meal is provided because overtime work necessitates an extension of the employee's normal work schedule and (C) the meal is provided to enable the employee to work overtime. Treas. Reg. §1.132-6(d)(2)(i)(A) through (C). Treas. Reg. §1.132-6(d)(2)(i)(C) provides the example that "meals provided *on the employer's premises* that are consumed *during the period* that the employee works overtime...satisfy this condition." (emphasis added).

D. Section 162 expenses.

The taxpayer also claims that certain expenses associated with entertainment or de minimis fringe expenses were inadvertently included as meals and entertainment subject to the 50 percent limitation but should be fully deductible simply under section 162. An expense associated with an expense that the taxpayer claims falls under an exception to the 50% rule would likely fall under the 50% rule as well (or possibly an exception). See Treas. Reg. §1.274-2(b)(2)(i) defining expenditure to include "goods, services, facilities and items" and section 132(e)(1) defining "de minimis fringe" as "any property or service..." The legislative history of section 274(n) states that "meal" and "entertainment" have the same meaning as under present law. Committee Report, P.L. 99-514. Further, the legislative history of section 274(n) reflects Congress' intent that the expenses subject to the limitation include any expenses related to the meal and entertainment expenses. "Expenses such as cover charges for admission to a night club, the amount paid for a room which the taxpayer rents for a dinner or cocktail party, or the amount paid for parking at a sports arena in order to attend an entertainment event there, likewise are deductible only to the extent of 80 percent [now 50 percent] under the rule. However, an otherwise allowable deduction for the cost of transportation to and from a business meal (e.g. cab fare to a restaurant) is not reduced pursuant to the rule." Committee Report, P.L. 99-514.

E. Taxpayer's treatment of expenses for refund claims.

From a strictly legal perspective, the analysis done by [redacted] to determine which expenses qualify as exceptions under section 274(n)(2) to the 50% general rule is inadequate.

First, with regard to the expenses treated as recreational

under section 274(n)(2)(A), [redacted] failed to actually determine whether a given event primarily benefitted highly paid employees. [redacted] did not perform any analysis under section 414(q) as required by section 274(e)(4). Determining whether officers or directors attended may be helpful, but it is not in any way determinative that highly paid employees did not primarily benefit. See Treas. Reg. §1.274-2(f)(2)(v). Further, in some situations it is difficult to discern from the documentation provided and vague description of the event whether the event was truly social or recreational. It is possible that many of the events may correctly fall under section 274(e)(4). However, again, from a strictly legal perspective, the taxpayer has not met its burden of proving the elements required to except the expenses from section 274(n)(1) via section 274(e)(4)..

[redacted] cited Langer v. Commissioner, 59 TCM 740 (1990) for the proposition that to be deductible under section 274(e)(4) the taxpayer need only show that the event was recreational and involved an employee. In Langer, one of the issues involved the deductibility of a company's expense for three Broadway show tickets purchased for two individual owners and one "employee." The Tax Court held that the ticket price for the employee was deductible in full but that the tickets for the owners were not deductible at all. The Court stated that the employee was an "employee within the meaning of section 274(e)(5) [now 274(e)(4)]." The Court never specifically addressed section 274(n). Therefore, the taxpayer's argument that Langer implicitly stands for the proposition that any employee who is not an owner, director or officer is considered an eligible employee under section 274(e)(4) is not persuasive. The plain language of section 274(e)(4) and Treas. Reg. §1.274-2(f)(2)(v) includes "highly compensated employees." The more reasonable reading of Langer is that when the Court stated that the employee was "an employee within the meaning of section 274(e)(5)" it determined that the employee was not an officer, director, ten percent owner or a highly compensated employee. See Treas. Reg. §1.274-2(e)(v) Further, in Langer the Court disallowed the entertainment expense in full with regards to the owners. [redacted] did not indicate that it backed out any of the expenses with respect to officers, director or highly paid employees.

Second, with regards to expenses claimed to fall under the general rule of section 1.132-6(a),[7] [redacted], for most of the expenses, does not satisfy the legal requirements. [redacted] did not determine in all situations what the frequency of the fringe

[7]The column on the revised spreadsheet with the heading "De Minimis Benefits (coffee, muffins....)"

was provided to employees, as lists of employees receiving the fringe were not always available. Generally, [redacted] claimed that it would have been administratively impossible to do this. [redacted] could not determine the frequency by which individual employees benefitted nor could [redacted] determine frequency by looking at the workplace as a whole as allowed under Treas. Reg. §1.132-6(b)(2) because [redacted] claimed it was not aware of who was at many of the events or meals. Further, [redacted] did not initially determine what the cost per employee was for a given meal.

Where the number and identities of the attendees were not available, [redacted] claims that pursuant to Rev. Proc. 63-4, it need only identify "the class of individuals." In these situations, [redacted] does not identify the individuals who were entertained nor the number of individuals entertained. Also, based on the descriptions of the events provided, it can not be ascertained which or what number of employees attended a given event. We do not agree with [redacted]'s application of Rev. Proc. 63-4 to this case. Rev. Proc. 63-4 at Question 15 posits, "If a taxpayer entertains a relatively large number of people, must he record each of their names?" The answer given reads in full,

> "No. If any situation where a class of readily identifiable individuals is involved, a designation of such class would be sufficient. For example, if a taxpayer entertains all of the stockholders of a small corporation, a designation such as 'all of the stockholders of Acme Corporation' would be sufficient. On the other hand, if the identity of a class, such as 'customers of X corporation,' is not sufficient to identify the persons entertained, then an individual designation of each person entertained would be required. Even in this latter case, however, persons entertained may be readily identifiable from a more general designation such as "Mr. Jones, branch manager of Y Co., and his 15 salesmen."

The examples provided in Question 15 only involve situations where the class of individuals is unrelated to the taxpayer. It is arguable that Rev. Proc. 63-4 should not even apply to the entertainment and de minimis exceptions to section 274(n)(1) since these exceptions only deal with situations where the class of individuals is the employees (and possibly guests) of the taxpayer and therefore should be known. Also, the individuals within the " class" in the Question 15 examples can be identified if necessary, in both name and number. In our case, for the situations which [redacted] claims Rev. Proc. 63-4 applies, neither

the names nor number of employees is available. Rev. Proc. 63-4 instructs that absent the ability "to identify the persons entertained, then an individual designation of each person entertained would be required." Id..

If the agent can determine frequency, value and the number of attendees, the agent can make a determination of whether to allow a full deduction under the de minimis exception.

With regards to the expenses claimed to fall under "group meals/ overtime meals"[8] a threshold problem is that it is not known which of these expenses are intended to fall under Treas. Reg. §1.132-6(a) and which are intended to fall under Treas. Reg. §1.132-6(d)(2)(i). For the meals which fall under Treas. Reg. §1.132-6(a), the same problems set forth in the preceding paragraph are applicable.

[redacted] stated generally that expenses for which the overtime rule applied, the meal time itself constituted the overtime. Our office does not agree with this proposition. Treas. Reg. §1.132-6(d)(2)(i)(B) and (C) state that overtime work necessitates an extension of the employee's normal work schedule and the meal is to enable the employee to work overtime. The regulations treat the "meal" and the "period that the employee works overtime" as two separate items. Treas. Reg. §1.132-6(d)(2)(i)(C). The logical reading of Treas. Reg. §1.132-6(2)(i) is that the meal itself is not considered the overtime but rather as a preliminary matter the taxpayer must establish that the employee was actually working overtime. The meal is then provided to enable the employee to work that overtime. For the meals which fall under Treas. Reg. §1.132-6(d) the taxpayer has failed to establish that the meals were necessitated by overtime. Our office informally discussed [redacted]'s approach to the overtime meals rule with attorney Dan Boeskin from our National Office who handles section 132 issues. Mr. Boeskin agreed with our analysis and conclusions.

[redacted] in her oral presentation intimated that value was irrelevant under the overtime exception. Our office does not agree with this. Treas. Reg. §1.132-6(d)(i)(2), while not specifically referring to "value" does state that the benefit must be "reasonable." Further, Treas. Reg. §1.132-6(d)(4) refers to "value" of the benefits discussed in Treas. Reg. §1.132-6(d). The proposition that the value does not factor into the equation in determining a "de minimis" fringe would defeat

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[8]The column on the spreadsheet with the heading "De minimis Benefits (employee group meals/ overtime meals)"

the concept of "de minimis." Mr. Boeskin agreed with this as well.

[redacted] asserted that there should be no difference whether the meals were provided on the employer's premises or off site at a restaurant. Generally, from a legal standpoint, our office agrees that there is nothing in the statute, regulation or any other authority which requires that the two be treated differently. However, if the taxpayer argues that a dinner at a restaurant fits under the overtime rule, *factually* it would likely have an unconvincing argument. The argument would be even less convincing if the dinner was scheduled well in advance. Also, Treas. Reg. §1.132-6(d)(2)(i)(C) provides an example of the overtime rule where the meals are provided *on the employer's premises* and consumed *during the period* that the employer works overtime.

[redacted]'s analysis also asserts that certain expenses associated with entertainment or de minimis fringe expenses were inadvertently included as meals and entertainment subject to the 50 percent limitation but should be fully deductible simply under section 162. The majority of these expenses are directly related to the meals and therefore should be considered under section 274(n). *In reviewing these expenses, the agent should consider* section D. above, in particular the legislative history citations.

On an aside, [redacted] repeatedly stated that [redacted] did not consider 80% of the potential expenses found in the employee expense reports. While [redacted] may be correct that the employee expense reports contain ample "opportunity" to apply exceptions to the 50% rule, this is an issue that is mutually exclusive from whether [redacted] has met the legal requirements under sections 274 and 132 for the expenses which they did in fact consider.

IV. Conclusion.

The examination team is currently reviewing the individual expenses claimed by [redacted] to fall under the exceptions to section 274(n)(1). We recommend that the team review the expenses with this advisory in mind. As discussed above, we generally conclude that [redacted] did not adequately address the legal requirements necessary to meet the entertainment and de minimis exceptions to section 274(n)(1). If the team determines that an expense does not meet the requirements of an exception or questions remain whether the expense meets the requirements because of inadequate substantiation, we recommend that the team disallow the additional 50 percent deduction sought for the

expense. As [redacted] noted at the [redacted] meeting, it may seek to provide additional information if necessary.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please note that this advisory memorandum is subject to post review by our National Office. If you have any questions please contact attorney Robert T. Bennett of our office at (973) 645-3244.

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